No. 87-464

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

TEXACO INC. and TENNECO OIL COMPANY,

Appellants,

—vs.—

DIRECTOR, DIVISION OF TAXATION,
NEW JERSEY DEPARTMENT OF THE TREASURY,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF NEW JERSEY

BRIEF OPPOSING MOTION TO DISMISS OR AFFIRM

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Appellee's contentions to the contrary notwithstanding (Motion 13),[1] the issues presented herein do not merely concern how much of each appellant's unitary income New Jersey may properly tax and whether there is a quantitative distortion that is substantial enough to warrant this Court's constitutional scrutiny. Rather, the questions presented herein directly implicate constitutional limitations upon a fundamental, qualitative aspect of State taxation of interstate activities—the definition of the "income" base subject to apportionment. As such, they are substantial and their resolution should establish principles applicable to any situation in which a State has expanded its tax base—whether through an "add-back" to net income, a deduction disallowance or otherwise—to include a discrete value incident to an out-of-state activity.

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1 "Motion" refers to Motion to Dismiss or Affirm filed by appellee in No. 87-453, and, by incorporation, in this appeal.

Indeed, the broad ramifications of the questions presented herein are evident even in appellee's arguments, which, though varied, may be reduced to a single assertion: A State may tax any values it can fit into the tax base it has defined, as long as it subjects that tax base to a facially valid apportionment formula. As the briefs filed by *amici curiae* make clear, the effect of such a view of State taxation would extend well beyond the situation presented in this case.[2]

Appellee's attempts to controvert the substantial nature of the questions presented on this appeal must also fail because they address only the form of the New Jersey Corporation Business Tax Act ("CBT") as applied and not its substance. Thus, appellee repeatedly relies on certain semantic characterizations respecting the CBT, to the exclusion of any consideration of its practical effect as applied herein. These characterizations serve at best to obscure the real issues.

For example, appellee vigorously asserts that N.J. Stat. Ann. 54:10A-4(k)(2)(C) (West 1986) does not provide for an add-back of WPT to net income but rather operates "merely" to deny a deduction from gross receipts subject to apportionment and taxation (Motion 18-19). However, whether characterized as a denial of a deduction from gross receipts or as an addition to net income, the practical effect of New Jersey's inclusion of WPT in each appellant's "entire net income" base under the CBT is to subject that amount to taxation. Thus, the CBT, like the WPT itself, specifically taxes the appreciation in the intrinsic value of crude oil at the wellhead due to deregulation, beyond the extent to which that value is reflected in any income realized from appellants' activities in New Jersey. It is this practical effect that is determinative. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 288 (1977).

That the CBT as applied, no less than the WPT itself, does in fact impose a tax on the severance or removal of crude oil is clear from the following illustration, in which the value taxed

2 *See also* the Brief in Opposition to Motion to Dismiss or Affirm filed in No. 87-453, which is hereby incorporated herein by reference.

by the WPT is plainly isolated from any income properly attributable to New Jersey. In this example, an integrated oil company (1) extracts 100 barrels of crude oil in a State other than New Jersey, which are sold at the wellhead for $20 per barrel and as to which WPT is incurred at a 70% rate on a "windfall profit" of $10 per barrel;[3] and (2) purchases 100 barrels of crude oil on the open market for $20 per barrel, which it refines and sells in interstate commerce at $30 per barrel, 10 barrels being sold in New Jersey. Revenues and expenses for each set of transactions may be summarized as follows:

		Per Barrel	Total
(1)	100 bbl. crude oil extracted and sold at wellhead	$ 20	$ 2,000
	Production (extraction and removal) costs	(8)	(800)
	WPT incurred	(7)	(700)
	Net income from crude oil sales	$ 5	$ 500
(2)	100 bbl. crude oil purchased, refined and sold in interstate commerce	$ 30	$ 3,000
	Cost of crude oil purchased	(20)	(2,000)
	Refining and marketing costs	(5)	(500)
	WPT incurred	0	
	Net income from refined oil sales	$ 5	$ 500
	Total net income		$1,000

Without any add-back of (or denial of a deduction for) WPT, the oil company's "entire net income" subject to appor-

3 In practical effect, it makes no difference whether the crude oil is actually sold at the wellhead to third parties or is instead subject to an intracompany transfer. This is because the WPT, and so the CBT as applied, is imposed upon the value of crude oil upon its severance and removal pursuant to an actual or *constructive* sale at the wellhead. *See* 26 U.S.C. § 4988; 26 C.F.R. § 1.613-3(2).

tionment is $1,000. Assuming a 5% apportionment ratio pursuant to the CBT apportionment formula,[4] the amount subject to taxation in New Jersey is $50. However, with the add-back of WPT, the company's "entire net income" under the CBT is increased to $1,700 ($1,000 total net income plus $700 WPT incurred) and the amount subject to tax in New Jersey is increased to $85. The additional $35 subject to tax in New Jersey upon the add-back of WPT to "entire net income" can only be attributed to the incidence of the WPT upon the severance and removal of crude oil *outside* New Jersey, and not to any activity *within* New Jersey. Through the add-back of WPT, the CBT is thus imposed on a discrete value not attributable to New Jersey.

Appellee's reliance on *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207 (1980) (Motion 14-16), is therefore misplaced. There, the Court held that Wisconsin could include the *unitary net income* derived from out-of-state oil production in an integrated oil company's apportionable tax base. 447 U.S. at 227-30. The Court did *not* hold, as appellee appears to suggest (Motion 14), that values beyond a company's unitary net income may be included in a State income tax base—whether through the disallowance of a deduction for an out-of-state cost or otherwise.

Appellee's discussion of *Commonwealth Edison Co. v. Montana*, 453 U.S. 609 (1981), is no more helpful to its position. Indeed, it is telling that appellee apparently equates Montana's imposition of a severance tax on the mining of coal within that State with the application of the CBT at issue herein (Motion 22). New Jersey here, like Montana in that case, is effectively taxing at least a portion of the value of a resource upon its severance or removal. However, while the Court upheld the singling out of a particular activity for taxation in *Commonwealth Edison*, the very rationale that supported the validity of the Montana severance tax there establishes the constitutional infirmity of the CBT as applied

4 N.J. Stat. Ann. 54:10A-6 (West 1986).

here. As the Court emphasized in that case, the Montana tax was incident to the severance of coal, " 'the only nexus of [which] is established in Montana' "; the entire value of the coal incident to its severance and prior to its removal was thus subject to taxation exclusively by Montana. 453 U.S. at 617, 624. In contrast, the intrinsic value of crude oil at its removal does not arise in, and cannot be attributed to, New Jersey; yet, as discussed above, New Jersey taxes this value incident to the severance and removal of crude oil in other States as effectively as if it directly imposed a severance or "windfall profit" tax of its own.

Although the appellee attempts to blur this determinative distinction (Motion 22), the absolute nexus of the incident of taxation to Montana in *Commonwealth Edison* cannot be equated with the lack of such nexus in this case. The Due Process and Commerce Clauses proscribe State taxation of a value wholly incident to an activity within another State as plainly as they allow the situs State to tax that value in its entirety. Accordingly, the application of N.J.Stat.Ann. 54:10A-4(k)(2)(C) (West 1986) to increase each appellants' apportionable "net income" under the CBT Act to include the amount of WPT, which is incident to the removal of crude oil in other States, violates the Due Process and Commerce Clauses.

The Court should note probable jurisdiction.

Respectfully submitted,

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